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Business Tax Breaks in Massachusetts

By Kurt Wise

Executive Summary

Ultimately the goal of state economic policy is to raise the living standards of the people of the state. This generally requires jobs that pay good wages and provide decent benefits. The crucial questions of economic policy are about how to create an environment in which businesses that create such jobs can prosper. What levels of education and what skills do such employers need their employees to have? What type of transportation infrastructure do these businesses need for their employees to get to work and for their distribution networks to operate efficiently? What help do these businesses need gaining access to capital? Are there types of technical assistance that can help them to operate more effectively, and how important are special tax breaks that the state might offer? What is the appropriate role of government in each of these areas?

In Massachusetts, the state supports economic development through spending on education, transportation, and other investments made both through the state operating budget and the capital budget. In addition, the state "spends" a significant amount through the tax code, providing tax breaks to various businesses. Because business tax breaks are, in many ways, the least well understood component of our state's economic development related investments, we make these the object of our analysis in this report.

Using Department of Revenue estimates, MassBudget calculates that in FY 2012 the Commonwealth will forgo collection of $2.44 billion in tax revenue in order to provide businesses with fifty-eight tax breaks that, broadly defined, are intended to directly support the state's economic development. Only about half of these tax breaks (together costing $770 million annually), however, are best-described as primarily being part of the state's actual economic development *strategy*. In this report, we refer to these thirty-one tax breaks as *special business tax breaks* and it is these tax breaks on which we most specifically focus our analysis.

The amount of revenue forgone annually in order to pay for these *special business tax breaks* has grown by $428 million over the last decade and a half, from $342 million in FY 1996 (adjusted for inflation to 2012 dollars) to $770 million in FY 2012. This rate of growth outpaces that of the state economy over the same period, meaning that Massachusetts now devotes a larger share of its available resources to fund these tax breaks than it did in FY 1996. Meanwhile, overall spending on the state budget has fallen modestly as a share of the state economy, as has spending on most program areas within the budget.

The cost growth of *special business tax breaks* primarily results from the ongoing addition of new *special business tax breaks* to the state's tax code; the Commonwealth has created more than a dozen new *special business tax breaks* during the FY 1996 – FY 2012 period. In particular, cost growth has been driven by increased spending on *sector-specific tax breaks*, a set of tax breaks available only to businesses operating in particular industries. This includes items such as the single sales factor tax breaks provided to manufacturers and mutual fund companies, and more recently, spending on the Film Tax Credit.

Given that Massachusetts has finite resources available to invest in its economic development – a limitation felt even more keenly during these economically and fiscally challenging times – it is imperative that the state's economic development dollars be invested thoughtfully and to maximum effect. As such, the state's *special business tax breaks* generally – and *sector-specific tax breaks* in particular – are overdue for a careful analysis of their costs and benefits.

Introduction

Every state in the nation devotes some portion of its resources to economic development, hoping to build a strong state economy, one that improves the prospects of its businesses and its residents. A useful definition of a strong and healthy economy is one that is able to employ the job seeking population in good jobs with good wages and benefits, and that maintains a high quality of life for the whole population over time. Or, as a recent Harvard Business School report succinctly defines it, a strong economy is one that allows firms "to compete globally while supporting high and rising living standards" for the general population.[1] A successful economic development strategy helps provide the conditions under which an economy with these features can flourish.

In Massachusetts, we make a variety of direct investments in our state's economic development. Like other states, we do this both through spending on specific programs and through tax breaks we provide to businesses. We also make many investments that are aimed primarily at achieving other goals but which nonetheless have a large impact on our state economy, including investments in education and in our transportation infrastructure.

The scale of these investments varies. We do not have unlimited resources, however, and so it is important to understand whether the investments we *are* making are likely to achieve the results we want. It is equally important to know whether other types of investments would be likely to produce similar results at lower cost or perhaps produce better results altogether. While answering these questions will require a thorough cost-benefit analysis of the most promising options for investing the state's available economic development dollars, an essential *first* step is to inventory and understand how the Commonwealth *currently* is spending its limited economic development resources.

In this report, we begin work on that first step. Of all the investments the Commonwealth makes on behalf of state economic development, tax expenditures are in some ways the least visible and the least understood. We identify, categorize and offer descriptive analysis of the many economic development-related tax breaks the Commonwealth provides to businesses. We break down overall spending on business tax breaks into useful categories and show how spending on these different categories has changed over time. We conclude by placing these numbers into a meaningful context, comparing the growth in this "tax code spending" to growth in the size of the state economy, to growth in spending on the overall state budget, and to changes in spending on each of the major program areas within the state budget.

To be clear, it is not our goal in this report to examine the overall structure of business taxes in Massachusetts, much less the quality of the state's "business climate"; instead we are focused narrowly on the topic of business tax breaks. We do not take a position in this report on whether business tax breaks or some other type of spending is the more cost-effective way to help grow our state economy; as noted, such a determination will require further research and analysis. What the data presented in this paper show, however, is that the real cost to the Commonwealth of *special business tax breaks* has increased markedly over the past 16 years,

[1] Porter, Michael E. and Rivkin, Jan W., "Prosperity at Risk", January 2012(pg. 3): http://www.hbs.edu/competitiveness/pdf/hbscompsurvey.pdf

greatly outpacing both growth of the state's economy and growth in the state's budgetary spending. Understanding this fact offers a useful starting point for further research into and analysis of the state's overall approach to economic development.

The Role of Business Tax Breaks in Economic Development

Like most states, one of the primary ways that Massachusetts spends the dollars available for economic development is by providing special tax breaks to businesses. The goal of this "tax code spending" is typically to encourage businesses to relocate to Massachusetts or to expand their current in-state operations (for further discussion of the terms "tax code spending" and "tax expenditure", see Appendix C).

A variety of factors influence the decisions made by businesses on where to locate their new or expanding operations. They include the quality of a state's infrastructure; the skills of its workforce; the proximity to materials and customers; and the overall quality of life available to employees.[2] A particular state's tax policy - including the variety of tax exemptions, deductions, credits, deferrals and special tax rules geared toward attracting and retaining business (collectively referred to as tax breaks or "tax expenditures") - also plays a role, though not a primary one.[3] Nevertheless, state governments often focus their economic development strategies heavily on these tax breaks.[4]

The Tax Expenditure Commission

In 2011, the Legislature created a Tax Expenditure Commission (TEC) to examine the Commonwealth's tax code spending and to report back with recommendations.

The TEC issued its report in April of 2012, recommending, among other things, that the Legislature define a clear public policy purpose and measurable outcome for each tax break, that all tax breaks be subject to periodic review, and that the total number and overall cost of tax breaks be reduced.

The full TEC report can be accessed at: http://www.mass.gov/dor/tax-professionals/news-and-reports/tax-expenditure-commission-materials/

The effectiveness of business tax breaks, however, is rarely examined in any detail and there is relatively little data available to analyze. The one official source for data about the Commonwealth's tax expenditures is the Tax Expenditure Budget (TEB), updated annually by the Massachusetts Department of Revenue

[2] See Fischer, Peter, *Grading Places,* 2005, pgs. viii-ix.
[3] Thompson, Jeffrey, *Prioritizing Approaches to Economic Development in New England: Skills, Infrastructure, and Tax Incentives*, September 2010, pg. 10: http://www.peri.umass.edu/fileadmin/pdf/published_study/priorities_September7_PERI.pdf
See also testimony to the New Hampshire Legislature from Robert Tannenwald, former Director of Research for the public policy division of the Federal Reserve Bank of Boston. As Tannenwald notes, combined state and local taxes amount to a very small percentage of total business costs for the average corporation. As such, state taxes are unlikely to drive major location or expansion decisions by corporations: http://www.cbpp.org/cms/index.cfm?fa=view&id=3314
[4] This approach to economic development is very common, even as states underfund basic public investments such as infrastructure and higher education, despite evidence that these broad investments may be more important to business location decisions and economic growth than are tax breaks. See Thompson, Jeffrey, *Prioritizing Approaches to Economic Development in New England: Skills, Infrastructure, and Tax Incentives*, September 2010: http://www.peri.umass.edu/fileadmin/pdf/published_study/priorities_September7_PERI.pdf

(DOR). The TEB includes brief descriptions of each of the Commonwealth's many tax breaks. It also provides individual estimates for the annual revenue loss associated with most of these tax breaks, including estimates for the current fiscal year, the coming fiscal year and the prior fiscal year.[5] The TEB does not provide any estimates of job creation or other types of economic activity spurred by a given tax break, nor does it provide analysis of a tax break's overall cost-effectiveness. (As noted in the breakout box on page 2, however, the April 2012 report of the Tax Expenditure Commission recommends the Legislature establish a clearly articulated public policy rationale and accompanying, measurable set of goals for each of the state's tax expenditures.)

Drawing on the data that are available from the TEB (and from DOR directly), in this report we focus specifically on those tax breaks aimed at promoting economic development through reducing business costs, promoting job creation and encouraging business investment.[6] We do not attempt an analysis of the overall "business tax climate"; our analysis does not include business tax rates or loophole closures or many other elements of business tax policy.

Of the almost two hundred tax breaks listed in the TEB, we include in our analysis only those tax breaks that meet the following criteria: a) are available to businesses and from which businesses are the primary beneficiaries, b) do *not* have an obvious primary purpose *other than* promoting the state's economic development through tax benefits to businesses, and c) have a revenue impact that has been estimated by DOR and is listed in the TEB.[7] (See Appendix A for a more detailed discussion of the methodology MassBudget uses to determine which tax breaks to include in our analysis.)

Analyzing the Commonwealth's Business Tax Break Strategy

Most public discussions about business tax breaks in Massachusetts, whether in the media or among policymakers, reference a figure of about $2 billion in annual revenue losses.[8] Using the criteria outlined above, in this report we identify fifty-eight tax breaks that – when taken together – total to $2.44 billion in forgone revenue in FY 2012. (For a complete list of the tax expenditure items that we include in this analysis, please see Appendix B.)

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[5] For a lengthier discussion of the TEB, see the Appendix A at the end of this report. The TEB does not provide corresponding estimates for the number of jobs created or retained due to a given tax break, let alone the average wages and benefits of these jobs. Assessing the effectiveness of these specific Massachusetts tax breaks - in terms of meaningful economic development - therefore is very difficult if not impossible.

[6] Because neither the TEB nor any other official state document defines the goals and objectives of the Commonwealth's many tax breaks, in order to determine which tax breaks should be considered "business tax breaks", MassBudget has inferred the likely intent of each tax break based on DOR's explanations of how it functions and who derives the direct benefit of the given tax break. For a more detailed discussion of our methodology, see Appendix A.

[7] Tax breaks provided to businesses can and do occur in all three of the major tax categories: the corporate, sales and personal income tax categories. While many business tax breaks operate through reductions to the corporate income tax, other tax breaks provide reductions in sales tax obligations. Still other business-related taxes, particularly for smaller businesses, are paid by the business owners through their personal income taxes, and hence some business tax breaks operate by reducing personal income taxes for business owners. In some cases, a tax break may be applied to multiple tax categories. In this paper, MassBudget includes in its analysis all tax breaks that fit the described criteria, regardless of which tax category is affected by the tax break.

[8] See Audtior's report: http://www.mass.gov/sao/Special%20Reports/2011/TaxExpenditureReportPhase1.pdf
See also WGBH report, April 23, 2012: http://www.wgbh.org/articles/Commission-Targets-Corporate-Tax-Incentives-6082
See also SwampscotPatch webpost, March 20, 2012: http://swampscott.patch.com/blog_posts/mass-should-have-fewer-corporate-tax-breaks

Lost in any discussion that focuses solely on this $2.44 billion total, however, is recognition of the important differences among these fifty-eight business tax breaks. In fact, only a little over half of these tax breaks are best described as being part of the Commonwealth's actual economic development *strategy*. The others – while also affecting business costs and profitability - instead either are heavily influenced by decisions made at the federal rather than the state level or are designed principally to serve a larger tax policy objective beyond the goal of state economic development.[9]

To develop a clearer picture of the Commonwealth's spending on its economic development strategy using business tax breaks, we assign each of the fifty-eight business tax breaks to one of the following three categories:

1) ***Piggybacks*** – This category includes nineteen tax breaks that the Commonwealth provides to businesses because our state tax code "piggybacks" on the federal tax code. In these instances, in the absence of an alternate state tax rule, the Commonwealth defaults to the tax rules as defined under federal tax law.

   There are instances, however, where state lawmakers *have* created an alternate state rule, "decoupling" from the federal code and thereby disallowing use, for state tax purposes, of a particular federally-created tax break. Given that state lawmakers have opted to piggyback on some federally-created tax breaks while decoupling from others, it would not be unreasonable to view the state's piggybacked business tax breaks as part of the Commonwealth's overall business tax break strategy. However, because piggybacking on the federal tax code is such a common feature of state tax codes across the country, and because the existence of these tax breaks in our state code is heavily influenced by decisions made at the federal rather than the state level, altering or eliminating these tax breaks in Massachusetts becomes a more complicated decision. (For a more detailed discussion of this category of tax breaks, see Appendix E.)

Two New Business Tax Breaks

On top of the hundreds of tax breaks currently on the books in Massachusetts, new tax breaks continue to be added.

In 2011, the Commonwealth opted to conform to current federal tax law in allowing most businesses to carry forward their losses for up to 20 years, offsetting profits in future years and thereby reducing any future taxes owed. Prior to 2011, Massachusetts had allowed business to carry these losses forward only for five years. The Department of Revenue (DOR) estimates that by FY 2031 (by which time this tax break will be fully phased in) the state will forgo $92 million in revenue annually as a result of the change.

In 2011, lawmakers approved another tax break, reducing the capital gains tax rate to 3 percent for investments made in smaller Massachusetts start-up companies and held for more than three years. DOR estimates this tax break will cost the Commonwealth $13.5 million annually once it is fully phased in (by FY 2022).

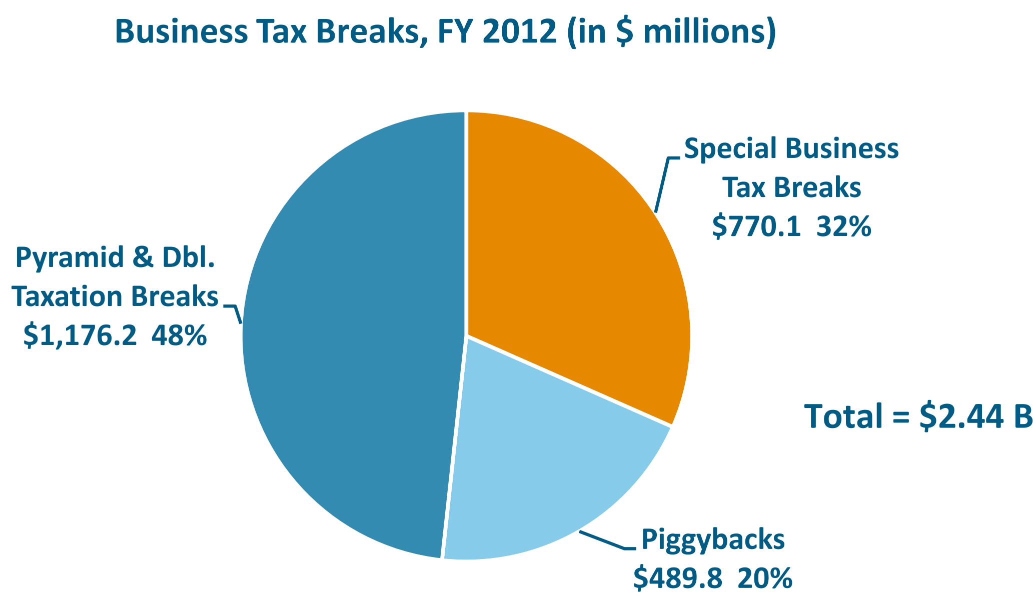
[9] While these tax breaks, like all state spending, also deserve careful review, a cost-benefit analysis of their value to the Commonwealth will hinge less on their potential impact on state economic development, as this is not the primary reason for their presence in the tax code.

2) ***Pyramiding and Double Taxation Breaks*** – This category includes eight tax breaks that serve the broader tax policy goals of a) avoiding tax pyramiding - particularly with regards to collecting the sales tax on purchases, made by businesses, of components that then become part of another product destined for retail sale and upon which the sales tax ultimately will be collected – or b) avoiding double taxation of businesses - for example, if a business has been taxed on its property at the local level, that property is exempted from state-level taxation. The purpose of pyramiding and double taxation breaks is less about economic development and more about the technical operation of the state tax system. (For a more detailed discussion of this category of tax breaks, see Appendix E.)

3) ***Special Business Tax Breaks*** – This category includes thirty-one special tax breaks that are best described as being part of the Commonwealth's actual economic development *strategy*. These special tax breaks do not derive from reflexive piggybacking on the federal code, nor are they aimed primarily at achieving some broad tax policy goal. Instead, these tax breaks offer benefits to companies that are engaged in specific activities, are part of a specific industry, or focus their activity in certain geographic locations. They are created and operate at the state-level and are structured in order to affect directly the costs of various business activities. We call the tax breaks in this category "*special business tax breaks*" and they are the focus of our analysis throughout the remainder of this report.

As the following figure shows, *special business tax breaks* will cost the state $770.1 million in FY 2012 (based on DOR's TEB estimates), accounting for almost a third of the total $2.44 billion revenue loss projected for that year. In the next section, we take a much more detailed look at these thirty-one *special business tax breaks*.

Figure 1.



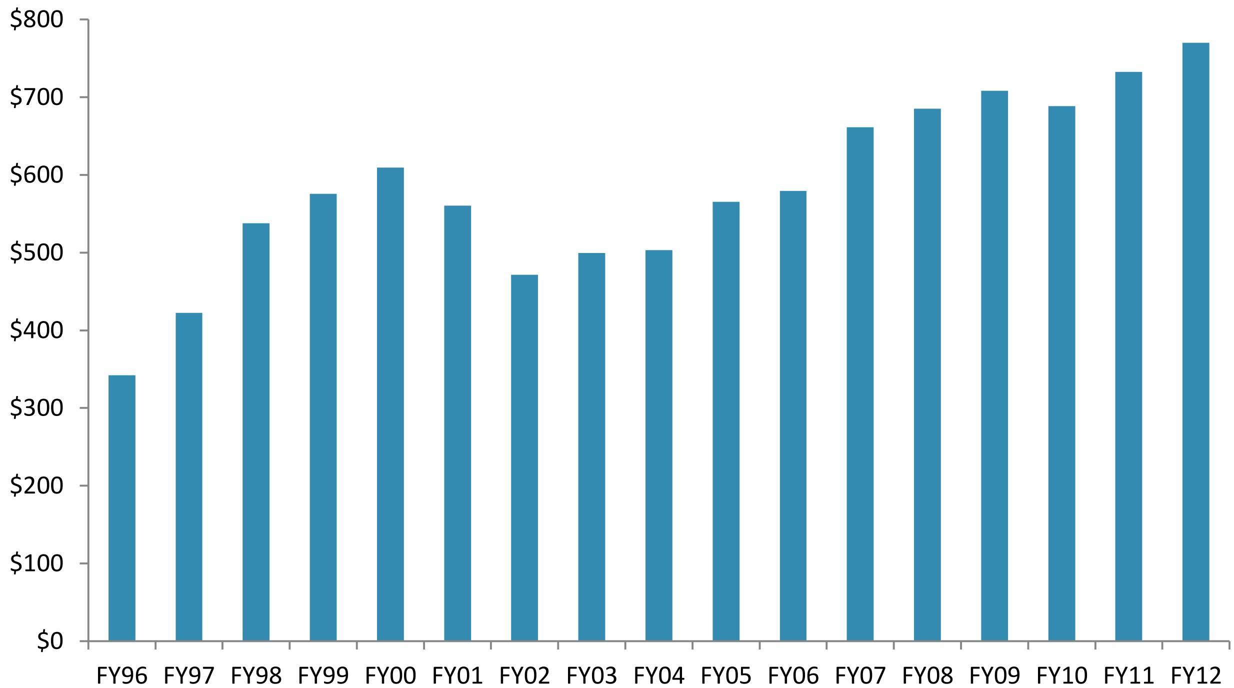
A Closer Look at the Commonwealth's Special Business Tax Breaks

As noted, the Commonwealth's thirty-one *special business tax breaks* will cost $770.1 million in FY 2012, accounting for approximately one third of the total revenue loss from the state's economic development business tax breaks in that year. The revenue losses from tax breaks in this category have increased from $342 million in FY 1996 (adjusted for inflation to FY 2012 dollars), more than doubling over the FY 1996 – FY 2012 period (see Figure 2, below). While periods of economic recession may temporarily arrest or reverse cost growth for several years, generally, once economic conditions improve, the cost of these tax breaks resumes its upward climb

Figure 2.

Special Business Tax Break **Costs Have More than Doubled, FY96-FY12**

Annual revenue losses in millions (inflation adjusted to 2012

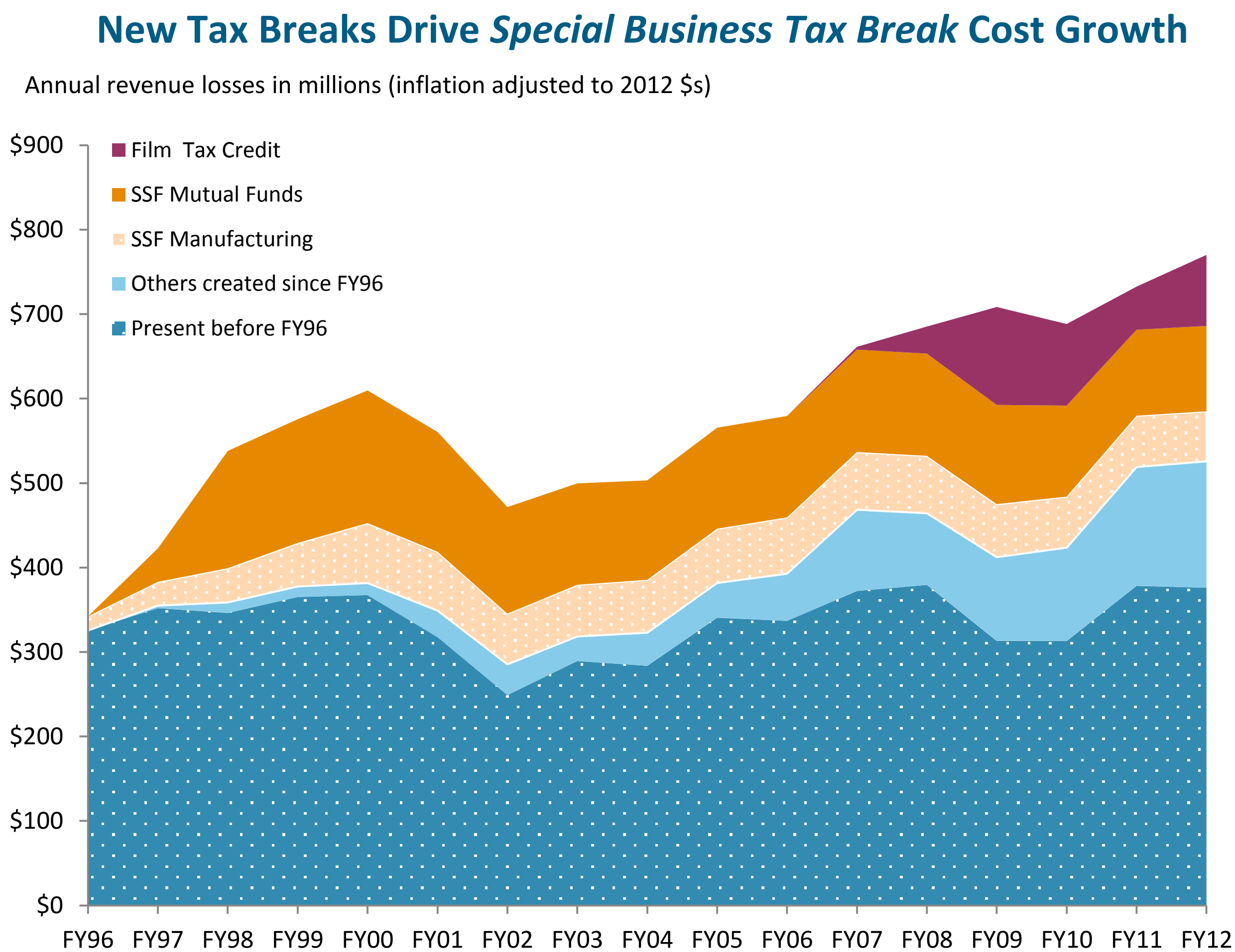


It is worth noting that the overall cost of these tax breaks would be higher still, had lawmakers not enacted in 2008 a series of business tax rate cuts that began steadily reducing rates from 2009 through 2012. Lower tax rates have the effect of reducing the dollar value of many tax breaks (see Appendix D for a more detailed discussion of this issue).

Much of the overall cost growth seen from FY 1996 to FY 2012 is driven by the ongoing addition of new *special business tax breaks* to the state's tax code (see Figure 3). The Commonwealth created more than a dozen new *special business tax breaks* during the FY 1996 – FY 2012 period. Among the most costly of these new *special business tax breaks* are the Single Sales Factor (SSF) tax breaks provided to manufacturers and mutual fund companies (created in the mid-to-later

1990s), and more recently, the Film Production Tax Credit, created in 2007 (we discuss these and other "sector-specific" tax breaks in greater detail in the next section of this report).

Figure 3.



In contrast to the rising cost of *special business tax breaks*, the inflation-adjusted values of both the *piggybacks* and the *pyramid and double taxation breaks* have fallen significantly over the same period. The share of the total represented by the *special business tax breaks* therefore has increased, growing from 18 percent of all the Commonwealth's economic development business tax breaks in FY 1996 to its current share, 32 percent (see Figure 1).

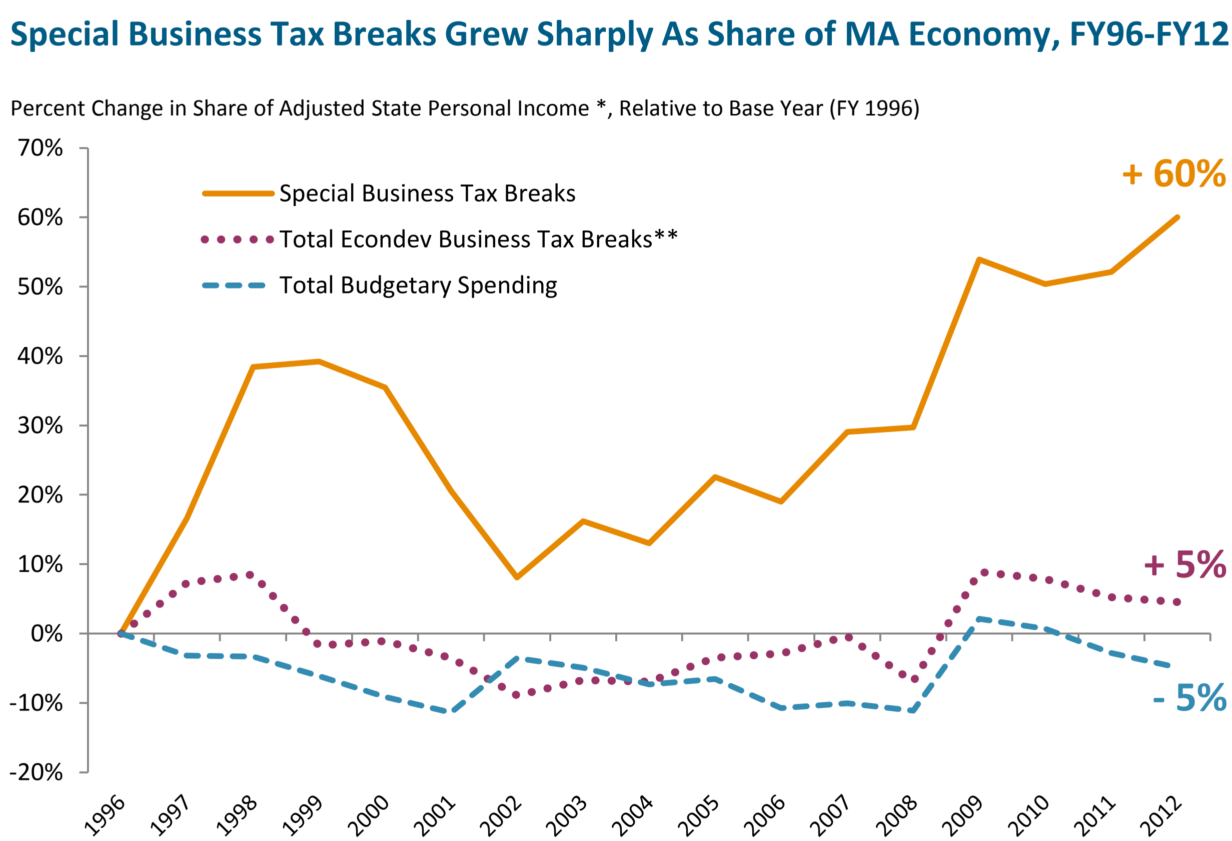
While it is important to be aware of the growth of the inflation-adjusted dollar amount spent annually on these *special business tax breaks,* those numbers alone do not tell the whole story. A more meaningful measure of the true cost of these tax breaks must take into account changes in the overall size of the state's economy.[10] In any given year, what share of our state's total

[10] For a more complete explanation of why taxes and/or spending are best measured as a share of State Personal Income (rather than in simple inflation-adjusted dollars or on a per capita basis), please see our factsheet on this topic: http://massbudget.org/report_window.php?loc=Facts_Comparison_Dec_2010.html

economic resources are we devoting to these special business tax breaks? How has that share changed over time?

Using State Personal Income as a measure of the state's total economic resources, we calculate that the size of the Massachusetts economy grew by over 40 percent during the FY 1996 – FY 2012 period (adjusted for inflation).[11] Growth in the cost of *special business tax breaks*, however, greatly outpaced that of the state economy as a whole. As a result, after adjusting for this statewide economic growth, by FY 2012 the cost of these tax breaks to the Commonwealth increased by 60 percent relative to FY 1996 levels (see Figure 4).

Figure 4.



* MassBudget adjusts US BEA state personal income figures as described in Footnote 11, below.
** Due to incomplete data, TEB item 3.302 is not included in the calculations for this trend line.

To place this rate of growth in context, we compare it to growth rates in other areas of state spending. Adjusting for overall economic growth, total state spending on *all* business tax breaks aimed at economic development ($2.44 billion in FY 2012) increased by 5 percent over the FY 1996- FY 2012 period.[12] (As noted earlier, however, the cost of business tax breaks would have

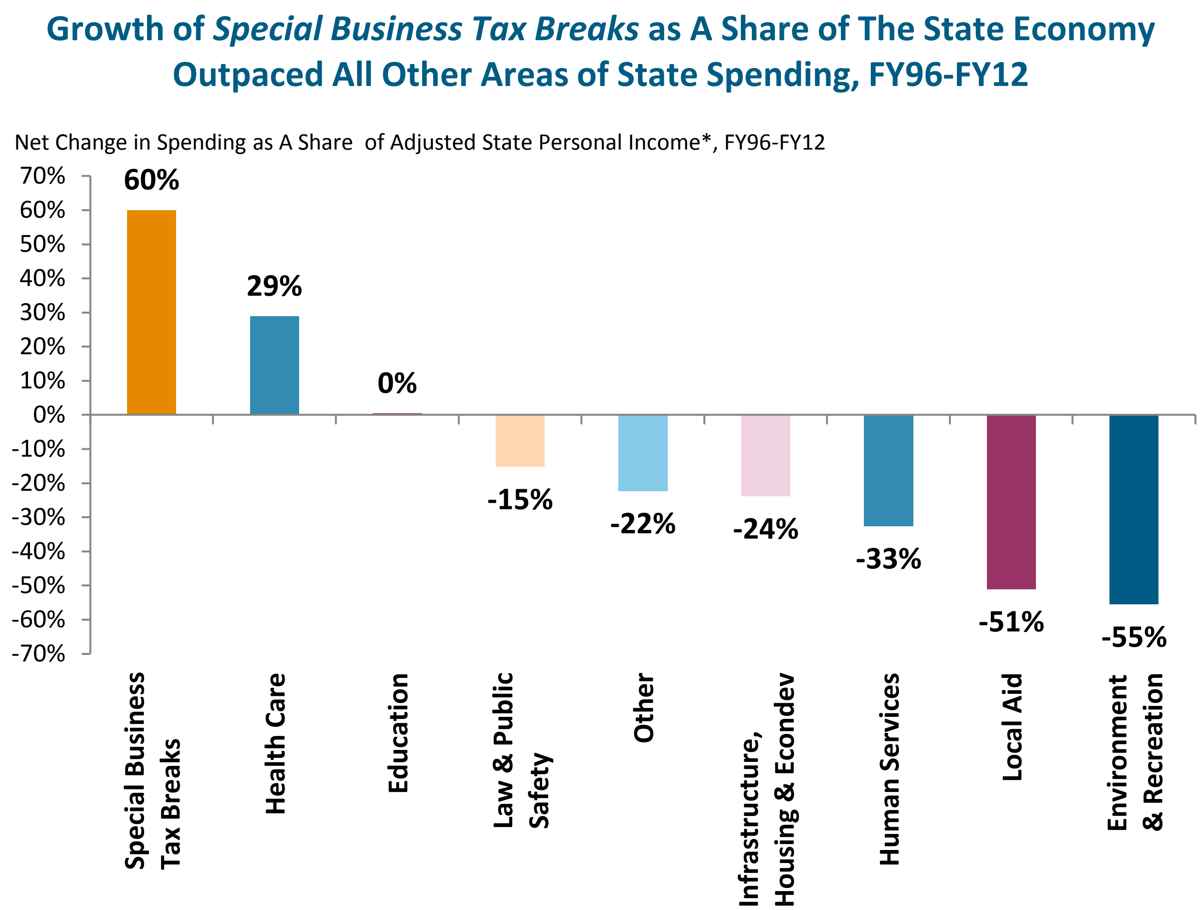
[11] US Bureau of Economic Analysis State Personal Income figures by state fiscal year, adjusted to include income from capital gains and income from non-resident taxpayers using the methodology published by the New England Public Policy Center of the Federal Reserve Bank of Boston, available at: http://www.bos.frb.org/economic/neppc/memos/2008/weinerpopov073008.pdf

[12] This substantially lower overall growth rate (+ 5 percent compared to + 60 percent for *special business tax breaks* alone) is the result of very limited inflation-adjusted cost growth for *pyramid and double taxation breaks* over this period and an actual decline in the

been higher had the state not begun a series of business tax rate reductions starting in 2009 (see Appendix D).) Looking at spending on the state budget as a whole, we see that budgetary spending declined modestly (by 5 percent) over this same period, again, after adjusting for growth in the Massachusetts economy (see Figure 4, above).

Taking a closer look at spending within the state budget, we break the state budget into its eight, primary areas of spending (see Figure 5, below) and find that spending declined – and declined markedly - in almost every one of these program areas.

Figure 5.



* MassBudget adjusts US BEA state personal income figures to include capital gains income and an adjustment for place of residence, according to a methodology published by the New England Public Policy Center of the Federal Reserve Bank of Boston: http://www.bos.frb.org/economic/neppc/memos/2008/weinerpopov073008.pdf

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inflation-adjusted cost of *piggyback* tax breaks. Adjusting these costs to account for state economic growth, we see that their combined costs decline significantly as a share of the economy, offsetting much of the cost growth of *special business tax breaks*. Note: The sales tax break provided for inputs to manufacturing (TEB item 3.302) has been removed from the calculations for the "Total EconDev Business Tax Breaks" trend line in Figure 4. DOR does not provide estimates for years 2004-2010 and the methodology they use to estimate 2011-2013 costs is different from that used for their 1996-2003 estimates, rendering these two sets of estimates non-comparable. Including the estimates DOR provides for 1996-2003 and FY2011-2013 would push the adjusted cost increase for "Total EconDev Business Tax Breaks" up to 17 percent for the FY 1996-FY 2012 period. However, given the data limitations described above, it is not clear that this would be an accurate portrayal of the true cost growth of these tax breaks as a share of the economy. As such, MassBudget removes these estimates from our trend analysis for "Total EconDev Business Tax Breaks" in Figure 4.

It should be noted that the increase in the cost of *special business tax break* is not the primary cause of funding declines in other areas of the state budget. Budget cuts made over the last decade have been driven in large part by the loss of revenue resulting from a variety of tax cuts - and in particular, the cuts made to the personal income tax during the late 1990s and early 2000s –[13] as well as by the increasing cost of healthcare (which limits the amount available to spend on other areas of the budget).[14] Had the cost of *special business tax breaks* remained a constant share of the state economy from FY 1996 to FY 2012, the Commonwealth would have spent $481 million on these tax breaks in FY 2012 rather than the estimated $770 million that actually will be spent. This growth in the share of the state economy devoted to *special business tax breaks* therefore will cost the state an additional $289 million in lost annual revenue by FY 2012. By contrast, overall state taxes as a share of the economy declined from 6.4 percent in FY 1996 to 5.4 percent in FY 2012, costing the Commonwealth $3.7 billion in reduced annual revenue by FY 2012.[15]

Clearly, *overall* revenue declines over the FY 1996 to FY 2012 period greatly outweigh losses specifically due to the rising cost of *special business tax breaks*. Nevertheless, the sharp growth we see in state spending on *special business tax breaks* is quite unusual; most areas of state spending have undergone deep cuts once we adjust for economic growth. The two exceptions are state healthcare spending and state spending on education: healthcare spending actually *increased* by 29 percent over the FY96-FY12 period, while education spending remained flat at zero percent change.

Breaking Down the Commonwealth's Special Business Tax Breaks

Having looked at the Commonwealth's *total* spending on *special business tax breaks* ($770.1 million in FY 2012) - and having seen how that spending has grown over time and how that growth compares to changes in other categories of state spending - we now take a more granular look at this set of business tax breaks, dividing them into several different groups.

Grouping these tax breaks based on the rules that determine which companies are eligible to receive each tax break allows us to understand better how the Commonwealth is allocating its tax break dollars as part of its economic development strategy and how those allocations have changed over time. To produce this more detailed look, we assign each of the thirty-one *special business tax breaks* to one of the following three groups:

1) *General Tax Breaks:* These tax breaks are automatically available to any company engaged in certain kinds of business activities. (One example is the Brownfields Credit, available to any company that cleans up and redevelops an abandoned or possibly contaminated property.)

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[13] DOR estimates that in FY 2012 the reduction in rate for Part B income from 5.95% to 5.3% will cost $1.206 billion, the rate reduction for Dividend & Interest income from 12% to 5.3% will cost $702 million, and the doubling of the personal exemption from $2,200/filer to $4,400/filer will cost $481 million. Together, these changes will cost the state and estimated $2.388 billion in FY 2012. Communication with DOR, January 17-18, 2012.

[14] For a more detailed discussion of this issue, see the MassBudget report *Substantial Surpluses to Dangerous Deficits*, January 2009: http://www.massbudget.org/report_window.php?loc=FiscalCrisisReport.html

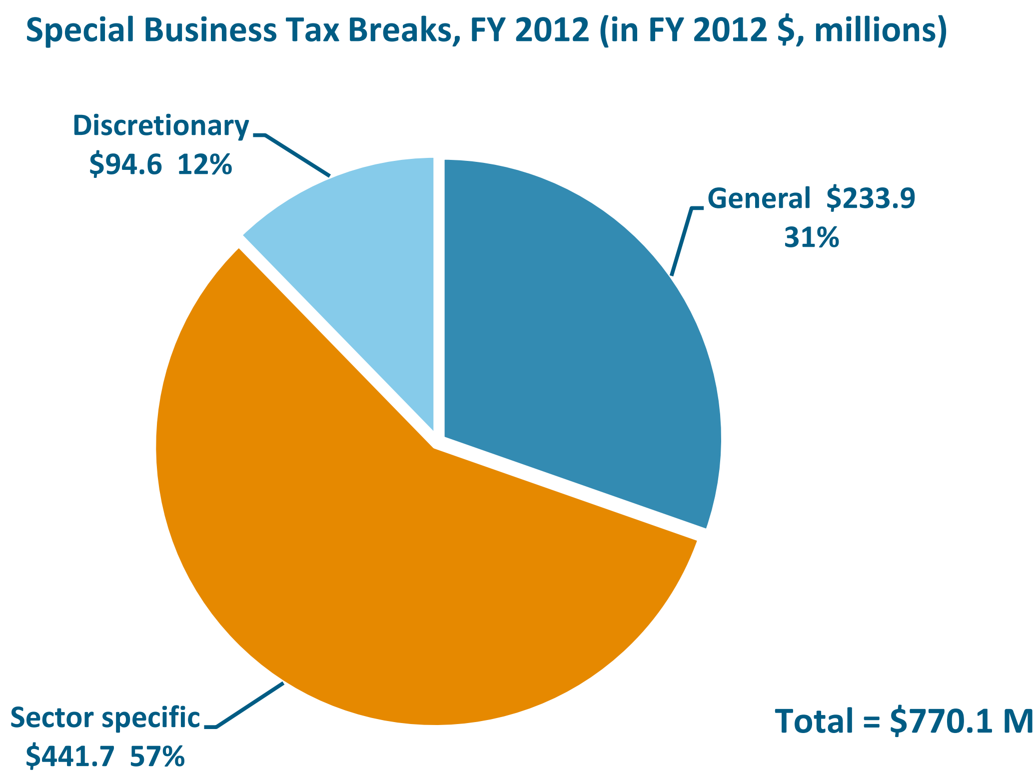
[15] DOR gives state tax collection totals for FY 1996 and FY 2012 at $12.049 billion and $21.117 billion respectively (in nominal dollars). Adjusted total state personal income for FY 1996 and FY 2012 is $189.256 billion and $389.552 billion respectively (in nominal dollars).

2) *Sector Specific Tax Breaks*: These tax breaks are automatically available as well, but only to companies within a specific business or industry sector. (Examples include the Film Production Tax Credit provided to film production companies, or the tax breaks provided to manufacturers and mutual fund companies.)

3) *Discretionary Tax Breaks:* These tax breaks are ones for which companies must apply and then must receive specific approval from a government agency in order to qualify. In some cases, these discretionary tax breaks are available only to companies operating in a specific sector. If active approval is required, however, we assign these tax breaks to the discretionary category. (Examples include the Life Sciences Tax Incentive Program and the EDIP/Economic Opportunity Area Credit.)

As Figure 6 below shows, *general tax breaks* currently account for close to a third of the total revenue lost annually by the Commonwealth through *special business tax breaks*. *Sector specific tax breaks*, meanwhile, account for over half of the total. Just twelve percent of the total is due to *discretionary tax breaks*.

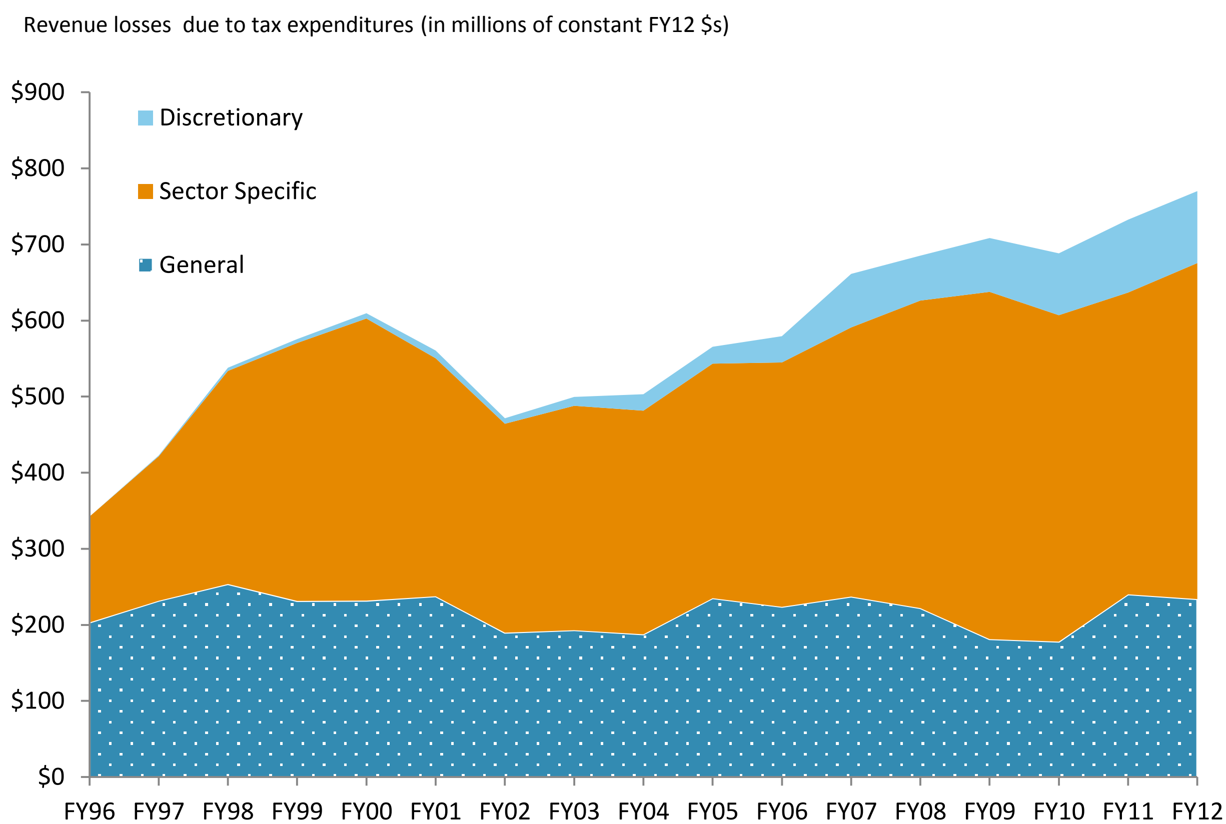
Figure 6.



As the *total* cost of *special business tax breaks* has grown over the last decade and a half (to $770.1 million in FY 2012), the *relative* costs of these three groups has changed as well. In FY 1996, for example, there were no *discretionary tax breaks*, while today the state forgoes close to $100 million in revenue annually for *discretionary tax breaks* (see Figure 7, below).

Figure 7.

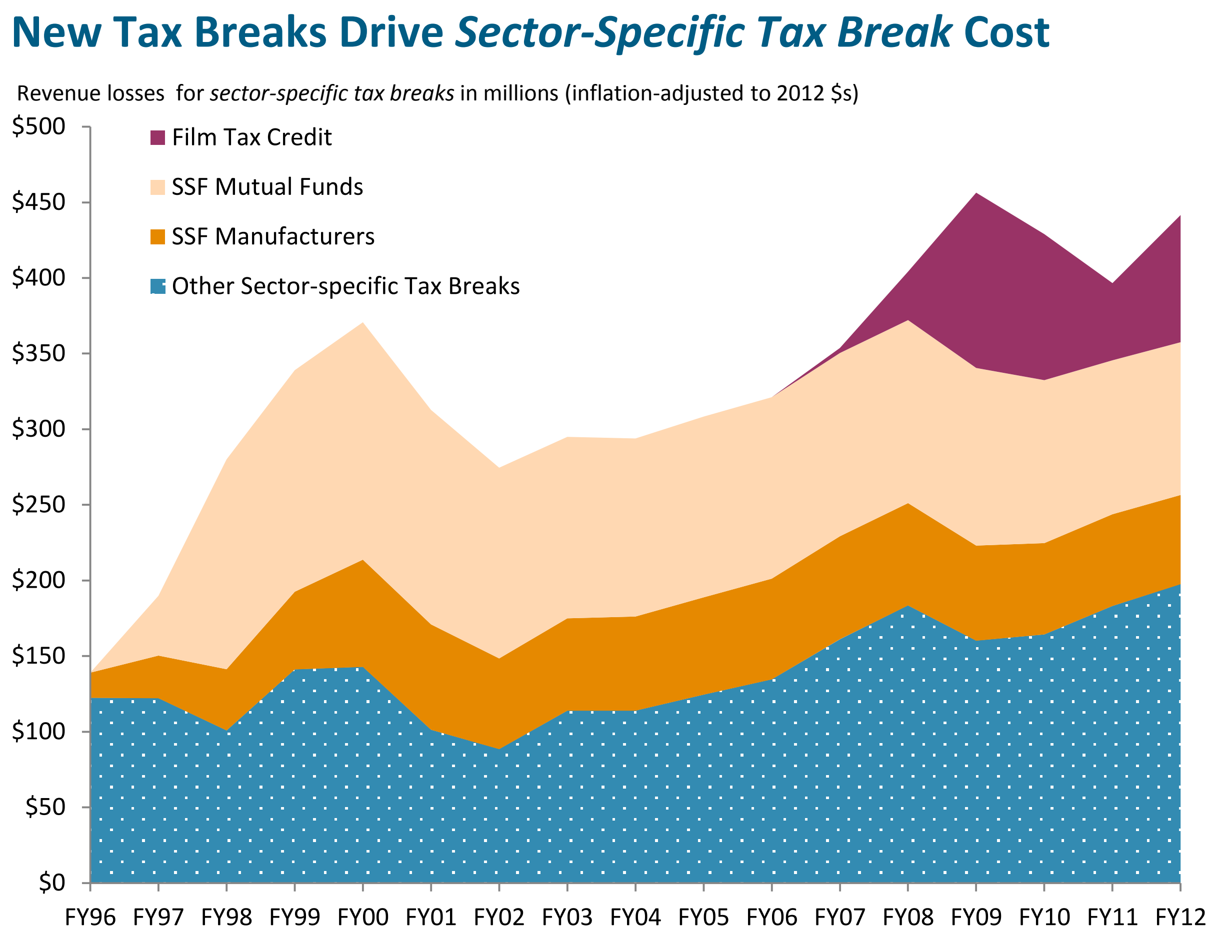
Sector Specific Tax Breaks Are The Costliest Special Business Tax Breaks



Similarly, both the real dollar amount and the *share* of revenue forgone to *sector specific tax breaks* was much smaller in the past than is true today, just $139.1 million (adjusted for inflation to 2012 dollars) or 41 percent of the total in FY 1996 compared to $441.7 million or 57 percent of the total in FY 2012 (see Figure 7, above).

The introduction of the "single sales factor" (SSF) tax break for manufacturers in 1996, and the extension of this tax break to mutual fund companies in 1997, produced a sharp increase in revenue losses due to *sector specific tax breaks* during the late 1990s (see Figure 8, below). Adoption of the Film Tax Credit produced another sharp rise in revenue losses starting in FY 2007. The SSF and Film Tax Credit tax breaks have contributed heavily to the three-fold increase from FY 1996 to FY 2012 in the amount of revenue forgone by the Commonwealth to *sector specific tax breaks*.

Figure 8.



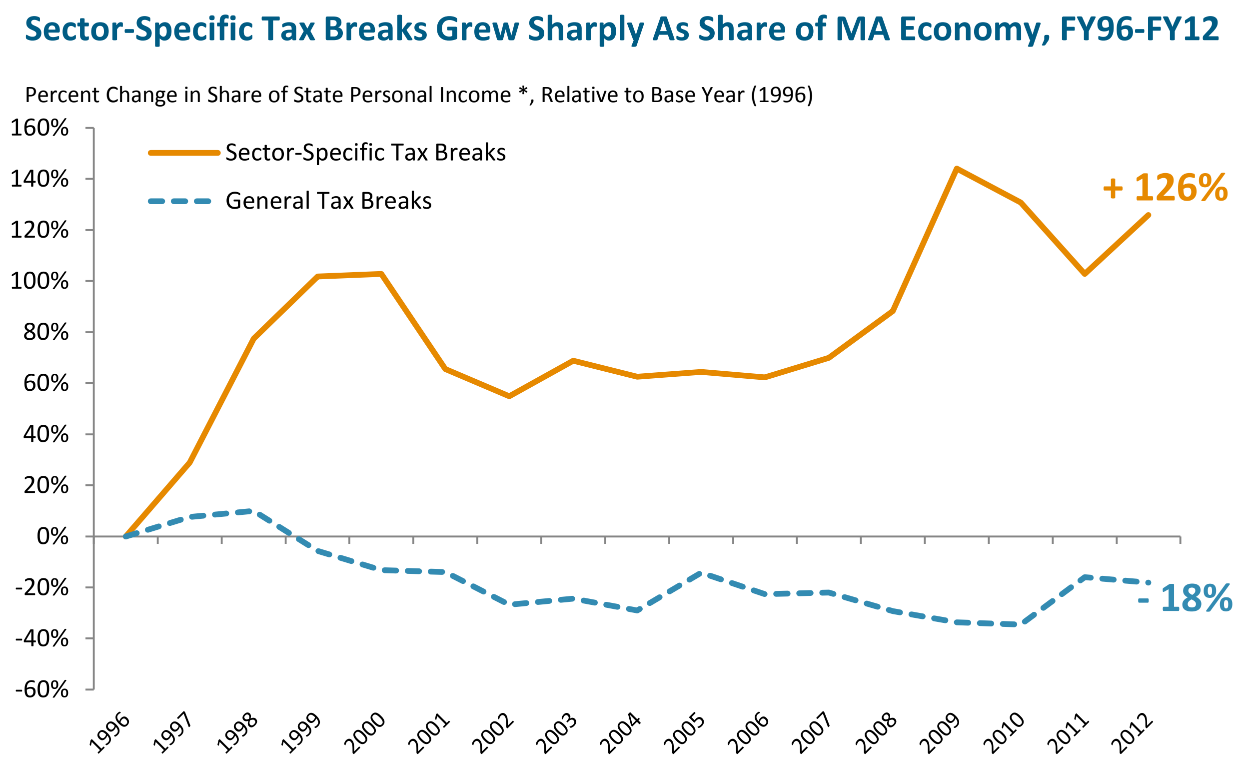
General tax breaks, meanwhile, have seen the least change in terms of total revenues forgone (see Figure 7, above). These tax breaks cost the state $203.2 million in 1996 compared to the $233.9 million that the Commonwealth will lose annually to these tax breaks by FY 2012. As the revenue losses from the other two categories of tax breaks (*discretionary tax breaks* and *sector specific tax breaks*) have grown, the share of the total *special business tax breaks* loss ($770.1 million) resulting from *general tax breaks* has fallen from 60 percent in FY 1996 to 31 percent in FY 2012 (see Figure 7, above).

Again, while it is important to be aware of the growth of the inflation-adjusted dollar amounts spent annually on these *special business tax breaks*, it is useful to place these numbers into a meaningful context. How has spending on these tax breaks *as a share of the resources available in Massachusetts* changed? [16]

[16] For a more complete explanation of why taxes and/or spending are best measured as a share of State Personal Income (rather than in simple inflation-adjusted dollars or on a per capita basis), please see our factsheet on this topic: http://massbudget.org/report_window.php?loc=Facts_Comparison_Dec_2010.html

Recalling that the Massachusetts economy grew by over 40 percent during the FY 1996 – FY 2012 period (adjusted for inflation), it is notable that the cost to the Commonwealth of *sector-specific tax breaks* grew by more than 125 percent over this same period (again, after adjusting for economic growth), or at more than three times the rate of the overall state economy (see Figure 9, below).[17]

Figure 9.



* MassBudget adjusts US BEA state personal income figures as described in Footnote 13, below.

Meanwhile, the cost of *discretionary tax breaks* also increased sharply over the last decade, though it is not possible to calculate an actual rate of increase.[18] We can see, however, that *discretionary tax breaks* began the FY 1996 – FY 2012 period at an annual cost of zero dollars and their cost has since risen to over $90 million per year. As these programs are discretionary - with annual caps on spending set for each program - increases in future annual revenue losses will require specific policy decisions by lawmakers to lift the current caps.

As noted above, the inflation-adjusted dollar cost of *general tax breaks* changed very little over this period, even while the state economy grew by some 40 percent. The result of these

[17] US Bureau of Economic Analysis State Personal Income figures by state fiscal year, adjusted to include income from capital gains and income from non-resident taxpayers using the methodology published by the New England Public Policy Center of the Federal Reserve Bank of Boston, available at: http://www.bos.frb.org/economic/neppc/memos/2008/weinerpopov073008.pdf

[18] As the initial cost of *discretionary tax breaks* was zero during the FY 1996 – FY 2012 period, it is mathematically impossible to calculate a rate of growth from the outset of the period in question. *Discretionary tax breaks* therefore are not included in Figure 9.

diverging trends is that spending on *general tax breaks* actually declined by 18 percent over this period, adjusting for economic growth. Again, the cost of many *special business tax breaks* would have been higher had lawmakers not enacted a series of business tax rate cuts beginning in 2010 (see Appendix D).

Conclusion

Given that Massachusetts has finite resources available to invest in its economic development – a limitation felt even more keenly during these economically and fiscally challenging times – it is imperative that the state's economic development dollars be invested thoughtfully and to maximum effect.

As noted in the introduction, in this paper we do not attempt the level of analysis required to gauge which investments would support, most effectively and efficiently, the state's long term economic development. What we *can* see as a result of the analysis provided in this report, however, is that the Commonwealth currently is spending in excess of three-quarters of a billion dollars annually on an approach to economic development centered around providing businesses with a wide variety of special tax breaks. We also can see that, adjusted for inflation, the amount the Commonwealth spends on these *special business tax breaks* has grown substantially over time.

Still more importantly, we see that the *special business tax breaks* provided as part of this strategy have grown more rapidly than the overall Massachusetts economy and thus are consuming an increasing share of our total available resources. Moreover, even as spending on these tax breaks has grown as a share of the state economy, by this same measure, spending on most program areas within the state budget has undergone deep cuts – and many of these program areas directly affect the state's long-term economic prospects.

As part of any such assessment, the value of *sector-specific tax breaks*, the largest and fastest growing category of *special business tax breaks*, must be examined with special care. In addition, the value of each of the state's *special business tax breaks* must be weighed against other types of economic development investments the state might make using these dollars, including various on-budget expenditures, for things like public education and transportation infrastructure.[19] Only then will it be possible to assess whether the $770 million the state now spends annually on these tax breaks is being put to best use. Only then will it be possible to determine whether other investments could better achieve the state's economic development goals: to build a strong and healthy economy, one that allows our firms "to compete globally while supporting high and rising living standards"[20] for all of us who make the Commonwealth our home.

[19] For a good summary of the literature on this topic (including further citations) please see Thompson, Jeffrey, *Prioritizing Approaches to Economic Development in New England: Skills, Infrastructure, and Tax Incentives*, September 2010, pgs. 9-27: http://www.peri.umass.edu/fileadmin/pdf/published_study/priorities_September7_PERI.pdf
[20] Porter, Michael E. and Rivkin, Jan W., "Prosperity at Risk", January 2012(pg. 3): http://www.hbs.edu/competitiveness/pdf/hbscompsurvey.pdf

APPENDICES

Appendix A: Methodology

Based on the three criteria outlined below, we have identified fifty-eight business-focused tax breaks most directly affecting the state's economic development. It is these fifty-eight tax breaks that we include in our analysis. The three criteria are as follows:

1. The tax break is available to businesses and is one from which businesses are the primary beneficiaries.

2. The tax break does *NOT* have an obvious intended purpose other than promoting the state's economic development by providing tax benefits to businesses. For example, the Vanpool Credit (TEB item 2.603) is *not included* in our analysis; while businesses are the primary beneficiaries of this credit, the most obvious purpose of this credit is to reduce commuter traffic and thereby protect the environment rather than to promote economic development.

   Because neither the Tax Expenditure Budget (TEB) nor any other official document provides a clear statement of each tax break's underlying public policy rationale or intended purpose, MassBudget has selected each of the fifty-eight tax breaks included in our analysis based on Department of Revenue (DOR) explanations of how each one functions and who derives the direct benefit of the given tax break. (A brief explanation of each tax break is provided in the TEB and MassBudget acquired additional detail through direct communication with DOR.)

3. The tax break has a revenue impact that has been estimated by DOR and is listed in the TEB. (For a variety of technical reasons, including issues with data collection, the Department of Revenue does not provide revenue loss estimates for all tax breaks.)

There are many tax breaks that benefit businesses (and individuals) that we do not include in our analysis because they fail to meet one or more of our criteria. For example, purchases of electricity, heating fuels, and piped and bottled gas are not subject to the sales tax when the purchase is made for residential use or for certain qualified business uses. While some businesses benefit significantly from these tax breaks, the majority of the benefits accrue to residential rather than business users. MassBudget therefore does not include these tax breaks in our analysis.

Appendix B: Tax Breaks Included in MassBudget Analysis

TEB Item #	Tax Break Name/Description	Tax Type	MassBudget Category
1.203	Excess Natural Resource Depletion Allowance	Income	Piggyback
1.204	Abandoned Building Renovation Deduction	Income	Special, General
1.301	Accelerated Depreciation on Rental Housing	Income	Piggyback
1.303	Accelerated Depreciation on Buildings (other than Rental Housing)	Income	Piggyback
1.304	Accel. Cost Recovery System (ACRS) for Equipment	Income	Piggyback
1.305	Deduction for Excess First-Year Depreciation	Income	Piggyback
1.306	Five-Year Amortization of Start-Up Cost	Income	Piggyback
1.309	Expensing of Research and Development Expenditures in One Year	Income	Piggyback
1.312	Expensing of Certain Capital Outlays of Farmers	Income	Piggyback
1.603	EDIP/Economic Opportunity Area Credit	Income	Special, Discretionary
1.604	Credit for Employing Former Full-Employment Program Participants	Income	Special, General
1.608	Brownfields Credit	Income	Special, General
1.610	Historic Buildings Rehabilitation Credit	Income	Special, Discretionary
1.611	Film Credit, Payroll and Production	Income	Special, Sectoral
1.613	Medical Device Credit	Income	Special, Sectoral
1.614	Dairy Farmer Tax Credit	Income	Special, Sectoral
2.001	Small Business Corporations	Corporate	Piggyback
2.101	Deferral of Tax on Certain Shipping Companies	Corporate	Piggyback
2.202	Additional Deduction for Certain Business in a Poverty Area (UJIP)	Corporate	Special, General
2.203	Net Operating Loss (NOL) Carryover	Corporate	Piggyback
2.204	Excess Natural Resource Depletion Allowance	Corporate	Piggyback
2.206	Abandoned Building Renovation Deduction	Corporate	Special, General
2.301	Accelerated Depreciation on Rental Housing	Corporate	Piggyback
2.304	Five-Year Amortization of Start-Up Cost	Corporate	Piggyback
2.305	Accelerated Cost Recovery System (ACRS) for Equipment	Corporate	Piggyback
2.306	Deduction for Excess First-Year Depreciation	Corporate	Piggyback
2.307	Accelerated Depreciation on Buildings (other than Rental Housing)	Corporate	Piggyback
2.308	Expensing of Research and Development Expenditures in One Year	Corporate	Piggyback
2.309	Expensing of Exploration and Development.Costs	Corporate	Piggyback
2.401*	Unequal Weighting of Sales, Payroll, and Property in Apportionment Formula	Corporate	Special, Sectoral
2.502	Exemption for Property Subject to Local Taxation	Corporate	Pyramid/Dbl. Tax
2.602	Investment Tax Credit	Corporate	Special, Sectoral
2.604	Research Credit	Corporate	Special, General
2.605	EDIP/Economic Opportunity Area Credit	Corporate	Special, Discretionary
2.607	Credit for Harbor Maintenance Taxes Paid	Corporate	Special, General
2.608	Brownfields Credit	Corporate	Special, General
2.610*	Historic Buildings Rehabilitation Credit	Corporate	Special, Discretionary
2.611	Jobs Incentive Payment for Biotechnology and Medical Device Companies(*)	Corporate	Special, Sectoral
2.614*	Film Credit (Payroll and Non-wage production)	Corporate	Special, Sectoral
2.615	Medical Device-User Fee Credit	Corporate	Special, Sectoral
2.617	Life Sciences Tax Incentive Program	Corporate	Special, Discretionary
2.618	Dairy Farmer Tax Credit	Corporate	Special, Sectoral

Appendix B: Tax Breaks Included in MassBudget Analysis (continued)

TEB Item #	Tax Break Name/Description	Tax Type	MassBudget Category
3.004	Exemption for Sales to Motion Picture Production Companies	Sales	Special, Sectoral
3.112	Exemption for Aircraft and Aircraft Parts	Sales	Special, Sectoral
3.301	Exemption for Items Used in Making Clothing	Sales	Pyramid/Dbl. Tax
3.302**	Exemption for Materials, Tools, Fuels, and Machinery Used in Manufacturing	Sales	Pyramid/Dbl. Tax
3.303	Exemption for Materials, Tools, Fuels, and Machinery Used in Research and Development	Sales	Pyramid/Dbl. Tax
3.304	Exemption for Materials, Tools, Fuels, and Machinery Used in Furnishing Power, water, and steam	Sales	Pyramid/Dbl. Tax
3.305	Exemption for Materials, Tools, Fuels, and Machinery Used in Furnishing Power to an Industrial Manufacturing Plant	Sales	Special, Sectoral
3.306	Exemption for Materials, Tools, Fuels, and Machinery Used in Newspaper Printing	Sales	Special, Sectoral
3.308	Exemption for Materials, Tools, Fuels, and Machinery Used in Agricultural Production	Sales	Pyramid/Dbl. Tax
3.309	Exemption for Vessels, Materials, Tools, Fuels, and Machinery Used in Commercial Fishing	Sales	Pyramid/Dbl. Tax
3.410	Exemption for Containers	Sales	Pyramid/Dbl. Tax
3.413	Exemption for Plant and Seed	Sales	Special, Sectoral
3.414	Exemption of Feed	Sales	Special, Sectoral
3.416	Exemption for Commuter Boats	Sales	Special, Sectoral
3.418	Exemption for Fuels, Supplies, and Repairs for Vessels Engaged in Interstate or Foreign Commerce	Sales	Special, Sectoral
3.419	Exemption for Fuel Used in Operating Aircraft and Railroads	Sales	Special, Sectoral

*For these TEB items, the revenue loss estimates used in this report reflect additional detail provided by DOR. As a result, the totals for these estimates do not match those provided in the spreadsheets available through the DOR website: http://www.mass.gov/dor/tax-professionals/news-and-reports/tax-expenditure-commission-materials/

**Adjusted by MassBudget to allow for apples-to-apples comparison across years. For a more detialed discussion of how this adjustment was made, please see Appendix A of this report.

Appendix C

In Focus

Tax Expenditures: Spending through the Tax Code

Despite often being portrayed as fundamentally different, in many ways, direct budgetary appropriations and tax expenditures in fact are very similar. Both seek to achieve certain policy goals through the use of the state's economic resources, and both have an effect on the state's bottom line.

In the case of direct appropriations – or "on budget spending" - tax revenues collected by the state are allocated by the Legislature to various programs aimed at achieving a given outcome. In the case of tax expenditures, revenue that otherwise *would be due* to the Commonwealth simply is not collected, again with the aim being to achieve a given policy outcome. Portraying one method of allocating state resources as "spending" and another as "tax relief", however, has important implications for how each is viewed by lawmakers and the general public.

While budget appropriations and tax expenditures are similar in that they both "spend" state resources, they also differ in important ways. A primary difference is that budget appropriations must be reauthorized by the Legislature each year. By contrast, once written into the tax code, tax expenditures require no annual review or reauthorization by the Legislature; they simply remain in effect until lawmakers actively remove them from the books. This rarely happens. Instead, tax expenditures often become "invisible", largely forgotten by lawmakers and the general public alike, remaining in the tax code for years or decades, while costing the state hundreds of millions of dollars annually in forgone revenue.

The state's Tax Expenditure Budget (TEB), a document produced annually by the Department of Revenue, catalogs $24.80 billion in potential tax revenue that, due to various tax breaks and special rules, will go uncollected in fiscal year (FY) 2012.[1] This total encompasses a much broader range of tax breaks than those specifically aimed at fostering economic development. Many of the Commonwealth's tax breaks provide tax reductions not to businesses but instead to low and moderate-income families, amounting to billions of dollars a year in forgone revenue. Examples include items such as personal income tax exemptions for social security benefits ($810 million in forgone revenue in FY 2012), deductions for taxpayers with dependent children ($135 million in forgone revenue in FY 2012), and exemptions from the sales tax for both food ($660 million in forgone revenue in FY 2012) and clothing ($270 million in forgone revenue in FY 2012).[1] In this report, we do not examine these types of tax breaks.

In a departure from precedent, the FY 2012 state budget established a commission to review the Commonwealth's current tax expenditures. The commission was tasked with "consider(ing) the public policy objectives behind the grant of any tax expenditure, the metrics for measuring success in meeting those objectives and the need for additional reporting, sunset or clawback provisions." The commission released its report in April of 2012 including recommendations to institute regular review of all state tax expenditures, set automatic sunset dates on some tax breaks and reduce the overall annual cost of tax breaks.

Appendix D

In Focus

How Changes in Tax Rates Affect Tax Break Costs

Cutting business tax rates reduces both the amount of taxes businesses owe *and* the value of the tax cuts they receive from many types of tax breaks. The amount of state tax revenue forgone in a given year through business tax breaks is determined by a variety of factors. For many tax breaks, the principal factors are the amount of *profits* generated in a given year by businesses eligible to claim the tax break and the *tax rate* applied to (the taxable portion of) those profits.

Specifically, many tax breaks function by reducing the amount of income that is subject to taxation. The cost to the Commonwealth of the tax break therefore is equal to a) the amount of income removed from taxation by the tax break, multiplied by b) the tax rate applied taxable business income. The higher the tax rate applied to taxable business income, the greater the revenue losses resulting from a tax break that removes some of that income from taxation.

Let's look at a simple example: If a business has $1,000 of taxable income and the tax rate is 10 percent, the business owes the state $100 in taxes. If the state provides a tax break that reduces the business's taxable income by $50 (redefining this income as "non-taxable"), the business then owes only $95 in tax. The tax break has cost the state $5 dollars in lost tax revenue. But what if the tax rate were reduced? How would that affect revenue losses for the state?

If we reduce the tax rate in the example above, say to 5 percent, we see that the cost of the tax break to the state declines. With $1,000 of taxable income taxed at the new 5 percent rate, the business would owe just $50 in tax, only half as much as before. The tax break, however – the same $50 reduction in taxable income (from the example above) - now also would be worth only half as much, with the state forgoing $2.50 due to the tax break rather than the previous $5 revenue loss. So, cutting the rate reduces the amount of revenue lost to tax breaks (as well as reducing the amount of tax collected on the remaining, taxable portion of income). OK, but how does this relate back to changes in the total amount of revenue forgone by the Commonwealth to business tax breaks over the FY 1996 – FY 2012 period?

In response to increasingly aggressive tax avoidance approaches on the part of corporations operating in Massachusetts, in 2008 the Commonwealth enacted “Combined Reporting.” As a result, a number of loopholes in the state’s corporate tax laws were closed, thereby returning more revenue to the state. At the same time, a scheduled reduction in business tax rates was enacted, steadily reducing rates over a four year period, from 2009 through 2012.

While these rate cuts benefited corporations, they also reduced the benefits corporations received from many of the state’s tax breaks, as in the example outlined above. Business tax rates declined by approximately 10 percent over the 2009-2012 period. This in turn reduced the cost to the Commonwealth of many of its business tax breaks.

Appendix E: A Detailed Discussion of Two Categories of Business Tax Breaks

Using the criteria outlined in the methodology section above (see Appendix A), in this report we identify fifty-eight business tax breaks aimed, at least in part, at generating economic development. When taken together, these tax breaks total to $2.44 billion in forgone revenue for the Commonwealth in FY 2012.

There are, however, important differences among these fifty-eight business tax breaks. In fact, only a little over half of these are best described as being part of the Commonwealth's actual economic development *strategy*. We discuss these thirty-one *special business tax breaks* at length in the main body of this report. The other twenty-seven business tax breaks are either heavily influenced by decisions made at the federal rather than the state level or are designed primarily to serve a larger tax policy objective. As such, we view them as separable from the state's actual economic development *strategy*.

We provide a further examination of these other two types of tax breaks in the discussion below.

I. Federal Piggyback Tax Breaks

As seen in Figure 1 (on page 7 of this report), the smallest share (20 percent) of the $2.44 billion in forgone revenue results from Massachusetts piggybacking on nineteen different federal tax breaks provided to businesses. While legislators have chosen to “decouple” the Massachusetts tax code from some portions of the federal tax code, they have allowed these nineteen federal business tax breaks to operate as part of our state tax code.

As such, it would not be unreasonable to view the state's piggybacked business tax breaks as part of the Commonwealth's overall business tax break strategy. However, because piggybacking on the federal tax code is such a common feature of state tax codes across the country, and because the existence of these tax breaks in our state code is heavily influenced by decisions made at the federal rather than the state level, inclusion or removal of these tax breaks from the Massachusetts tax codes becomes a more complicated decision.[21] MassBudget therefore views these nineteen tax breaks as being different from the Commonwealth's other business tax breaks and we assign them to their own, separate category.

Much of the revenue loss from these “piggyback tax breaks” is the result of benefits provided to companies that are making capital investments or research and development investments, with some or all of that investment occurring here in Massachusetts. While additional investments by businesses are, in principle, a benefit to the Massachusetts economy, it is unclear to what degree the state’s tax credit increases the amount of investment a company undertakes. To the extent that businesses invest based primarily on factors dictated by the economy, the tax credit does

[21] While piggyback tax breaks are subject to the same set of trade-offs between costs and benefits to the Commonwealth as any other tax breaks, the default application of federal tax law in these cases does serve the purpose of reducing the complexity of tax filings for some businesses. Tax code simplicity is generally considered a desirable feature in and of itself, and as such, can be viewed as one tangible benefit associated with the piggybacking approach.

little to change corporate investment decisions and thus little to increase economic development, while costing close to half a billion dollars annually in lost revenues.

In terms of how these tax breaks actually provide their benefits, typically they function to reduce a taxpayer's taxable income. A sizeable portion of the overall revenue loss due to piggybacking results from a tax break that allows businesses to use the losses they have sustained in prior years to offset their taxable gains in the current (and future) year(s).[22]

II. Pyramiding and Double Taxation Breaks

As Figure 1 (on page 7 of this report) shows, the largest share (48 percent or $1.18 billion) of the $2.44 billion in FY 2012 business tax breaks will go toward achieving the broad tax policy goals of avoiding tax pyramiding and double taxation. Most of these revenue losses result from the exemption from sales taxes provided to businesses on their purchases of components used in the production process. Exempting these intermediary purchases avoids the problem of "pyramid taxation", wherein materials used directly in the production process are taxed multiple times as businesses purchase, assemble, and resell components to each other prior to a product's final retail sale. For example, in attempting to avoid pyramid taxation, states typically would not apply the sales tax to a purchase of tires by a company producing automobiles; the tires will be used in the production of a complete automobile and the sales tax will be collected on the total value of the car at the time the car is sold to an end-user.

Without such an exemption, the same input (e.g., the tires in the example above) could be taxed twice, once as an input to production and once as a final product, increasing costs either to producers or end consumers.[23] A sales tax exemption for items used in the production process, therefore, is a common feature of tax systems and is generally accepted as an element of sound tax policy.[24]

At the same time, this type of exemption presents a number of inherent difficulties. Tires used in the production of a car clearly fit into any definition of an "input to production", but what about the machines used to shape and weld that steel or the computers and software used to run those machines? Drawing the line between exempt purchases and purchases to which the sales tax applies can be problematic.

In addition to tax breaks aimed at avoiding pyramid taxation, there are tax breaks aimed at avoiding double taxation. A far smaller portion of the $1.18 billion revenue loss total (for combined pyramid and double taxation breaks) results from tax breaks preventing double taxation on business property; if business property has been taxed at the local level, the Commonwealth exempts this property from additional taxation at the state level.

[22] A change enacted by Massachusetts lawmakers in 2011 updates the state tax code to conform to current federal code as regards "Net Operating Loss Carryovers." Starting in FY 2016, businesses operating in Massachusetts will be able to carry their losses forward for up to 20 years for tax purposes, using these losses to offset any future taxable profits and thereby reduce taxes they otherwise would owe on these profits. For additional discussion of this issue, please see the breakout box on page 4 of this report.
[23] Institute on Taxation and Economic Policy, *The ITEP Guide to Fair State and Local Taxes,* 2011 (pg 20): http://www.itepnet.org/pdf/guide3.pdf
[24] Ibid